10-YEAR
PLAN FOR OREGON
REBUILDING OREGON'S HOUSE

BUILDING THE FOUNDATION FOR THE FUTURE

10-Year Plan for Oregon:
Fiscal Policy Recommendations to the Governor

April 2012

This document presents recommendations from the Executive Committee on the 10-Year Plan for Oregon to Governor John A. Kitzhaber, M.D. The recommendations outline an approach Oregon state government should take to achieve fiscal sustainability over the next 10 years.

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The 10-Year Plan for Oregon Executive Committee

Governor Kitzhaber in August 2011 created the 10-Year Plan for Oregon Executive Committee to provide diverse leadership for the 10-Year Plan for Oregon initiative, and to advise the Governor on fiscal sustainability and related policy and planning issues.

The 10-Year Plan for Oregon represents the foundation for implementing the Governor's vision to "Rebuild Oregon's House." The initiative will deliver a framework by which state government can create a new strategic plan, implement a 10-year outcome-based (results-based) budget, and achieve the following principles:

> **Principle 1:** State government should serve the needs of clients, citizens and taxpayers and does not exist to maintain any specific program, agency, or structure.
>
> **Principle 2:** State budgeting should focus on how to use available revenue and where to invest it to achieve desired outcomes.
>
> **Principle 3:** A long-term sustainable fiscal plan should include strategies to increase per capita income for Oregonians and reduce the cost-drivers of public safety and health and human service programs, increasing the revenue available to fund education.
>
> **Principle 4:** State managers should look for creative methods, including non-governmental providers, to administer programs and services efficiently and effectively within the resources available.
>
> **Principle 5:** State government should save resources in good economic times in order to maintain services when times are not good.
>
> **Principle 6:** The state's spending system should provide decision makers and the public with data on the results of expenditures, demonstrating responsibility for achieving results and ensuring public transparency.

This report represents recommendations of the 10-Year Plan Executive Committee; it provides a fiscal view of the state budget and its cost drivers and presents ways to increase stability given Oregon's current tax structure. The Executive Committee recommends specific actions by the Governor and Legislature to help the state secure a better budget process and fiscal stability for the important services that Oregon citizens rely on state government to provide. The Executive Committee offers these recommendations as a preliminary product of the planning process for the 10-Year Plan for Oregon.

The role of the Executive Committee is not to make choices for or author the 10-Year Plan, but to facilitate an understanding of the fiscal condition of the state and the choices that must be made to secure a prosperous future. Nevertheless, the Executive Committee comprises passionate Oregonians who were put together to push the state forward to the best of their ability, and they do not believe now is the time to be coy. The members welcome the opportunity to advise the Governor and to be a sounding board for citizens and the Legislature in the process of promoting deliberate change to stabilize state finances and spending practices.

This report is one component of what will be a robust body of work on budget and policy to:

- Develop a state outcome-based budget proposal;
- Create an integrated strategic plan for the future – the 10-Year Plan for Oregon.

Development of an outcome-based budget that allows state government to strategically invest in improving Oregon's systems of education, health and safety is vital to securing greater value from limited public resources. Such a framework will provide new means to define and measure improvement in program operations. It will provide a structure to stimulate and match private sector initiative and meet needs throughout Oregon.

Most importantly, an outcome-based budget will move the state forward in achieving Principle 1: "State government should serve the needs of clients, citizens and taxpayers and does not exist to maintain any specific program, agency, or structure."

The Executive Committee views an outcome-based budget framework and the 10-Year Plan as a platform for common action. Building a results-focused budget that builds on a progression of actions to attain the 10-year goals of the people of Oregon is central to capturing the opportunities necessary to position Oregonians for future success.

Over the next year, the outcome-based budget and the 10-Year Plan will be developed. The Legislature will then consider and refine these ideas and form a continuing process to engage Oregonians in defining outcomes and the future process of developing the 10-Year Plan. The clear vision for this plan is that it will mirror Oregonians aspirations for services and reflect their values with respect to allocation of limited resources.

Three Key Observations and the Need for Public and Private Collaboration

As the Executive Committee pursued its charge, members reached three key observations that establish context for recommendations made to the Governor.

First, the Executive Committee believes Oregon is in a fiscal crisis that will persist.

Second, the Executive Committee believes Oregon can best confront the crisis by stimulating a climate that rewards innovation in government and continues collaboration between the Governor and Legislature, like they forged in 2011 to deal with a drastic budget shortfall.

Third, while Oregon cannot control the global and national trends impinging the economy and state revenue growth, the economy can be stimulated through focused budget and policy actions that improve conditions for private sector investment and job creation.

From the outset, the Executive Committee desired to communicate the clear link between a strong government and strong private sector. Government policy and investment can create the conditions for a thriving private sector. In turn, a thriving private sector generates jobs and revenue, which support government services and new educational investments in a virtual cycle of prosperity.

While global trends will affect the ability to grow the economy, any actions to improve the expected slow economic growth, and reduce safety and social service costs, will provide critically important resources to invest in education, workforce training and the success of young children in schools. More importantly, it will provide income to Oregonians and provide them a means to support their families.

This highlights the necessity of a plan to intentionally make public investment decisions that stimulate private sector investment. Just a one percent increase in state revenues would have prevented the need to rebalance the budget in 2012. While easier said than done, small margins of change in economic activity and investment can have a very positive effect on citizens and improve government's ability to manage public programs without disruption during fiscally challenging times.

Government and private sector investments must be increasingly coordinated in support of a common goal of creating jobs and growing per capita income. Given the trends of economic projections and the best available information forecasting the budget, the Executive Committee is wholly aligned in recommending a strong focus on actions directed to incrementally exceed economic projections.

Since 1997, Oregon personal income levels have tumbled to 91-percent of the U.S. average, far below the state of Washington's 106-percent. Oregon's rural economies are stuck in the same rut they've been in since the 1980s. The new phenomenon is that the Portland region is performing very poorly compared to other metropolitan areas around the nation. In fact, Portland-Metro incomes lag significantly behind Denver, Minneapolis, Seattle, Austin and just about every other metropolitan area that Portland considers peers. Because of the personal income decline, Oregon has fewer tax dollars to invest in public services and thus must do a much better job of budgeting to meet the needs of citizens.

The Executive Committee's assessment about the economic uncertainty Oregon faces today is not a unique perspective. The ramifications of recent turbulent times apply to the nation and the rest of the world. Although Oregonians cannot control uncertain times, they do have choices about how to confront the difficulties uncertain times present.

Oregon's plan and path must be:

1. *Durable* and *reliable* as a basis for unified citizen action.
2. *Transparent* and *well understood* by all Oregonians.
3. *Focused* to extract the highest value from public and private investments made in Oregon.

The Executive Committee's conclusions and the recommendations that follow are aimed squarely at Oregon's serious fiscal problems and at aligning budget and spending policies to improve the ability of state government to create and execute a strategic 10-Year Plan for Oregon's future.

10-Year Plan for Oregon Executive Committee

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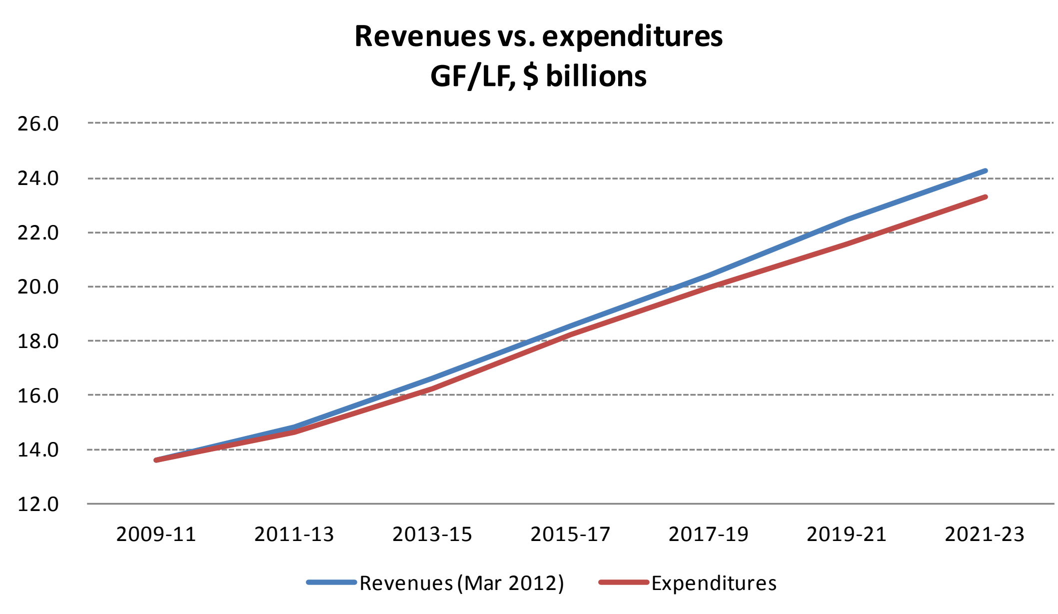
Introduction: A Continuing Challenge and Crisis

In his 2010 "Reset Report," Governor Ted Kulongoski warned of a "decade of deficits." The warning was clear and unqualified; Oregon could not afford to provide the same level of services, in the same way, into the future. While that report was correct in substance, it was less than accurate in effect. Governor Kulongoski and the Legislature made very difficult budget decisions in 2010, followed by nearly $3.5 billion in cuts made by Governor Kitzhaber and the Legislature in 2011. As a result, Oregon does not face a financial deficit today or into the future.

The real "deficit" is a deficit of services that state government can no longer provide in the future (or can no longer provide at previous levels of funding). This change, combined with the widespread belief that future economic growth will not allow for restoration of these services in the future, presents a continuing challenge.

Over the next decade, the effects of a structurally weak economy will inhibit state revenue growth. The amount of money Oregon's tax system brings in will barely exceed the cost of programs over the next 10 years – the cost of programs diluted by the 2011 budget reductions. This means Oregon is locked into a lower service level even with minor revenue enhancements.

Figure 1: General Fund, Lottery Fund revenues vs. expenditures



Source: State of Oregon, Budget and Management Division, Office of Economic Analysis

It can be anticipated that the economy will not move on a straight line of slow growth. The real picture is one in which Oregon's budget will fall out of balance with minor economic downturns and conversely, benefit with modest upturns.

In fact, preliminary information suggests that because of the use of one-time resources to close the budget gap in 2012, projected program growth would exceed revenues available to the 2013-15 budget.

Further compounding the state's budget risks, the federal government has already committed to significant spending cuts and more seem likely. The risk to the state budget resulting from federal cuts is arguably as high and as uncertain as it has ever been. It is not a given that Oregon can depend on continued or uninterrupted federal transfer payments to state programs.

While the state struggles to balance its budget, local governments — specifically in rural Oregon — are in dire financial trouble. Local governments that are primarily supported by property taxes are now caught between the limits of law related to growth in property taxes and the effects of the recession on reduced housing values, which is compounded by reduced state and federal transfer payments. At this time the financial stress is focused largely on southern Oregon counties with Curry County on the brink of a financial emergency.

Because of state government's weak financial position, it cannot be expected to fill the emerging gap in local government finances. In some cases, this could portend the collapse of local government services. A widely recognized issue is continuing federal Rural Stabilization Funds as a replacement for diminished timber-harvest tax receipts to counties. This issue highlights the fragility of government finances at the federal, state and local level. In addition, continuing federal payments or increased forest management activity remains elusive in the near-term.

The need for new ways of prioritizing and funding state programs is clear. Outcomes-budgeting and the 10-Year Plan for Oregon provide practical approaches to ensuring Oregon's future.

Section One: Outcome Budgeting

Adopting a Budget that Provides for Outcomes and Developing a 10-Year Plan

Today the budget is allocated to agencies and the Legislature debates one agency at a time. A new outcomes-focused budget process will end the practice of prioritizing spending by agency and institute a process of prioritizing <u>programs</u> for available funding because they deliver result regardless of which agency delivers the service.

At the direction of the Governor, Oregon State Government is designing a new budget process to make state spending decisions more transparent and results-focused. Central to this work is the creation of a 10-Year Plan that focuses on achieving six high-level outcome areas or for the citizens of Oregon:

1. Education
2. Healthy People
3. Economy and Jobs
4. Healthy Environments
5. Safety
6. Improving Government

The new outcomes-based budget will be designed to achieve defined spending priorities through specific policy strategies. This overall fiscal process will be guided by and designed to answer one vital question about state spending: Are we getting the outcomes we want?

Over the past several months all state programs, regardless of agency, have been mapped or associated to the outcome area with which the program has the greatest affinity. Each outcome area will have a defined amount of funding available to spend across programs. Teams of citizens will prioritize these programs based on the program's contribution to achieving citizens' goals. Programs that are preventative and recognized as vital to improving future outcomes, avoiding future spending, or saving money may compete for and receive additional incentive funds set aside for high-impact investments.

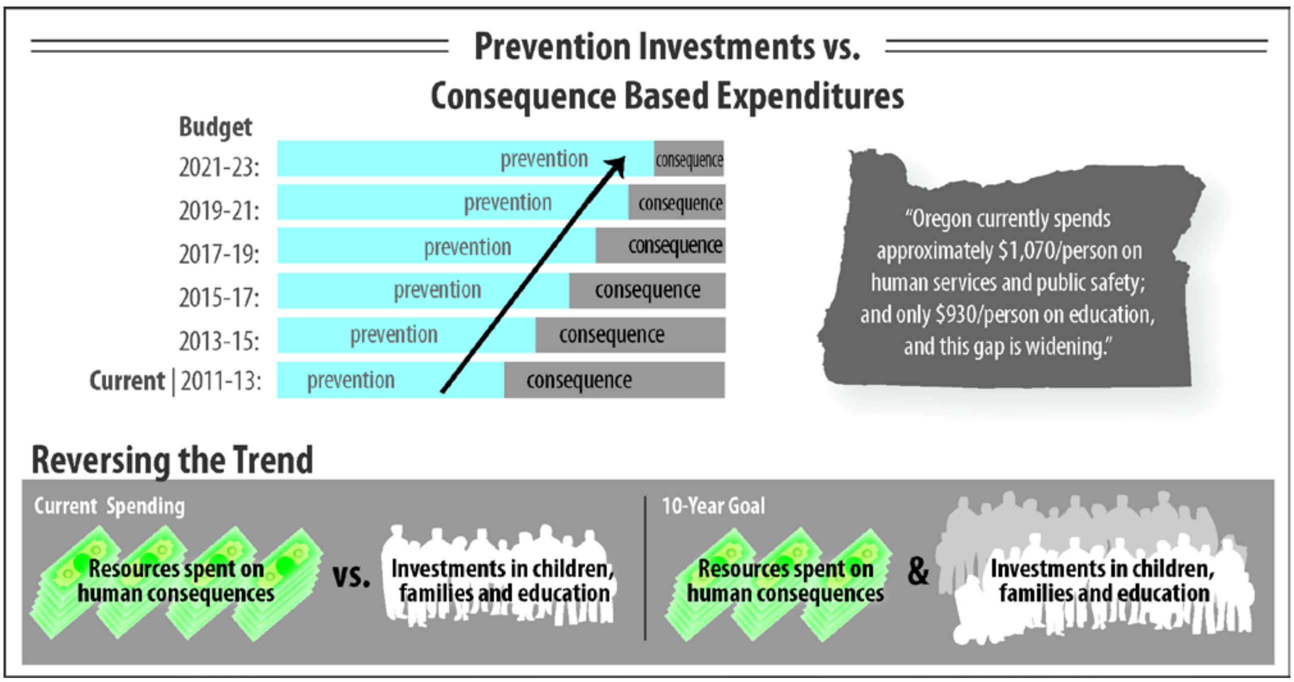
This approach provides a strong foundation for changing the results of state spending. State government should prioritize investments based on outcomes and thus increase its productivity. This must start by organizing around the results citizens expect government to achieve and deliver.

Simply put, the idea is to intentionally spend dollars to achieve specific and identifiable results in all outcome areas. This requires a process of transparent engagement to design clear spending plans to accomplish the goals of Oregonians, within available resources. The outcome areas will directly align with the services citizens want government to provide. This is very different approach from the process currently used to prepare and consider the state budget.

The budget is currently prepared without a long-term framework to guide it. Each two-year budget is the means to an end on delivering two-year public financial commitments. The multiple budgets over a decade are not strategically connected to achieve any specific purpose or outcome. This short-term focus allows the Legislature and Governor to “succeed” in balancing the budget without consideration for the long-term results.

The problem stems from little consistency of action or planned investment of funds to build on prior public investments. Prevention investments and cost cutting measures that take more than two years to materialize are not rewarded because the incentives that drive a two-year budget process carry a short-term focus. No successful business, public organization or household can achieve its long-term financial objectives without a plan to identify and achieve those desired outcomes.

Figure 2: Prevention Investments vs. Consequence Based Expenditures



It is vital that the budget is balanced, but that act is directed by Oregon law – when the money runs out the budget is balanced. An outcome-based budget creates incentives and rewards around what spending achieves; balance is a given because it is based on the funding that is available.

The 10-Year Plan will create explicit expectations that the spending of today should be directed to the cost control and achievements of tomorrow. Implementation of an outcome-based budget and the 10-Year Plan will allow Oregon to gain greater value from public investments.

The days of the “current service level” budget approach will end. The process will account for the costs associated with increasing population and inflation in funded programs, but all programs will not simply advance forward. Adoption of an outcome-based budget will end the days of the rear-view mirror approach to budgeting – the days of assuming that state government provides what citizens need if it just adds a little more funding to each program in every budget cycle.

Oregonians deserve a budget that is goal directed and designed to achieve results; a spending plan that is resistant to the whims of the political moment; a planned progression of investing available funds in consistent ways to attain desired citizen results.

Figure 3: Initial 10-Year Plan Outcome Statements Reflective of Citizen Desires

Initial 10-Year Plan Outcome Statements Reflective of Citizen Desires	
Education	Oregonians are prepared for lifelong learning, rewarding work and engaged citizenship.
Healthy People	Oregonians are healthy and have the best possible quality of life at all ages.
Economy and Jobs	Oregon has a diverse and dynamic economy that provides jobs and prosperity for all Oregonians.
Healthy Environment	Manage Oregon's air, water, land and wildlife resources to support a healthy environment that sustains Oregon communities, Oregon's economy and the places Oregonians treasure.
Safety	Oregonians will be safe where they live, work and play.
Improving Government	Government will be trustworthy, responsive and solve problems in a financially sustainable way.

These elements of the fiscal planning and budget reform effort will serve to improve citizen understanding of state spending and to improve budgeting decisions at all points of the budget development and approval process.

RECOMMENDATION 1.1: PRODUCE A RECOMMENDED BUDGET THAT IDENTIFIES HOW RESOURCES ARE ALLOCATED TO CRITICAL OUTCOMES. The budget should include a long-term fiscal roadmap that suggests a trajectory for future revenues and expenditures and how the expenditures relate to Oregon's long-term goals. To accomplish this aim, the process must account for the necessary tradeoffs enabling allocation of resources to the most important outcomes.

Leading a Process of Investment

Oregon's opportunity to successfully change the budget process and to approve long-term fiscal plans must begin at the top. The leadership of a Governor and a Legislature is essential. They must focus their efforts and be willing to confront stagnated systems of management, accountability and accompanying laws that keep state government shackled to the status-quo. This will require new systems for determining how to spend precious revenue streams for improved results – every spending decision should be analyzed for impact. The state desperately needs better analytics, structured data and information to support improved decision making by managers. Concurrent with this process, government decisions about outcomes must be transparent to the public and executed in a timely manner.

Like many Oregonians, the Executive Committee took pride in the way government leaders attacked the most dramatic budget gap in Oregon's history by working together in the 2011 and 2012 legislative sessions. Future success remains dependent on maintaining that principled path of finding common and effective actions despite individual differences in values. This is why the Executive Committee as a whole voices its pride and respect for the leadership of the 2011 and 2012 legislative sessions, in combination with the Governor's efforts. This was a good dose of what Oregon needs – focused and deliberative action and cooperation between the executive and legislative branches of government.

RECOMMENDATION 1.2: THE GOVERNOR SHOULD MAKE THE BUDGET DEVELOPMENT PROCESS OPEN TO THE LEGISLATURE. Develop legislation to ensure that the Oregon Legislature affirms statewide outcomes, provides for an outcome-based budget into the future, and establishes a bi-annual summit of statewide leaders to evaluate progress related to achievement of identified outcomes.

Providing for Public Engagement

An outcome-based budget depends on proper framing of the expectations of citizens, and while citizens' desires are diverse, common goals for spending can be defined at an aggregate level. This is not a revelation and governments have accomplished this goal through the process of public hearings for some time. However, an outcome-based budget and a 10-Year Plan anticipates more than merely gaining a common vision about public spending; it involves a process to determine what spending should achieve both *now* and in the *future*. While public engagement and participation is provided for, there is room to improve and enrich opportunities for public involvement.

Today a high-level of expectation exists that government can and should develop new ways to engage and communicate with citizens. The digital technologies that have created advanced social networks are not ubiquitously being applied to the relationship between citizens and government. Digital communication offers an opportunity to unify the common purpose of Oregonians with regard to state budgeting. This is but one example of actions state government can focus on to help actualize the Governor's vision that the 10-year planning process serve as a unifying framework for the many desires of citizens. The Executive Committee is committed to the idea of developing increased public engagement in the fiscal planning and budgeting process because that involvement will improve government decision making and government's ability to execute policy.

The Governor's appointment of this Committee and citizen teams to evaluate and make recommendations that prioritize the budget are beginning steps. So are the engagement of the "Citizens Cabinet" and Regional Solutions Centers, which facilitate opportunities for greater dialogue and participation, especially at the local level. The outcomes of the state budget are mostly achieved at the community level – community level data, analysis, and interaction must be a tangible objective in the development of an ongoing process.

This process is just beginning, yet it has required considerable technical effort to reframe the budget to the six outcomes areas. To date, limited opportunities for public engagement have been possible as the first steps of providing the substance for broader public and legislative engagement are in progress. It is fully the expectation of the Executive Committee that the level of public engagement and awareness about this process will increase between now and the advancing of the Governor's Recommended Budget on December 1, 2012. The Committee also expects that the 2013 legislative session will not only provide for focused dialogue about the outcome-based budget recommended by the Governor, but serve as a forum for guiding public engagement in fiscal planning going forward.

RECOMMENDATION 1.3: MAKE IT A HIGH PRIORITY TO IMPROVE PUBLIC ENGAGEMENT IN THE DEVELOPMENT OF OUTCOME-BASED BUDGETS AND THE 10-YEAR PLANNING PROCESS. The Governor should work to create citizen involvement opportunities within the budget development process and the Legislature should provide its guidance and support for improving public engagement when it meets in 2013.

New Tools for Success: Creating a Data-driven Budget Process

Oregon should place a high priority on the development of new informational tools for evaluating spending and place a higher degree of emphasis on spending as an investments in the future. Data and information can narrow the range of political disagreement and provide focus on actions. Analysis that arrays financial information and related program results more effectively than a "traditional budget" will provide new insights to spending decisions. As state government looks toward an outcome-based budget focused on results, the measurements of success become key determinates of how dollars should be allocated to public activities. The state must closely track and understand the benefits or "returns" on public investments. A need exists for government to invest in best practices that target services for results and create a shift in public spending from systems that manage resulting problems of dysfunction to prevention of problems in the first place. Investment in program evaluation and analysis from independent views will be valuable as the state fine tunes the budget for the greatest effect on the needs of Oregonians – both as taxpayers and as users of services.

The Executive Committee understands that this first effort will not be perfect; it will not be unassailable; it will not be a lot of things; what it *will* be is the beginning of change that government and Oregonians must go through together. For that reason alone, this action puts state government on the right path and the right course. The outcome-based budget will position the state to have a serious conversation and debate about changing the business of government and rebuilding it to support the capacity of individual Oregonians, and for the state as a whole to prosper in the future.

RECOMMENDATION 1.4: THE STATE SHOULD TAKE THREE SPECIFIC ACTIONS TO IMPROVE THE UTILIZATION OF DATA TO EVALUATE PROGRAM PERFORMANCE: 1) Develop a common chart of accounts and cost accounting system for budgeting that aligns program spending with the six identified outcome areas; 2) Develop clear metrics for evaluation of return on investments to achieve outcomes; 3) Create an independent Office of Program Evaluation and finance its operations.

Unbridling Government and Embracing Change

Oregon faces real risks - to the state's future prosperity, to the economy, and to the ability of government to offer the necessary services that will help grow a strong economy. The state must innovate and open up the channels of opportunity to change the future; many of the keys rest with the way the state makes decisions collectively as a government and how governmental programs are managed.

The 10-Year Plan Executive Committee believes an ongoing fiscal crisis is not manageable given current governance and business practices of the state. A fiscal crisis is still upon us, though it may not be as acute; the Executive Committee would characterize the fiscal outlook for the next 10 years as a time of continuing fiscal austerity.

The acute shortfall in revenue in 2011 made deep budget reductions a necessary first step to bring the budget into balance. Now the state has to anticipate continuously matching its budget to slower revenue growth and the implications of that for the ongoing delivery of public services; the shift of the state budget to a lower level will have a continuing impact on services going forward. By necessity, this will rightly focus government on distinguishing the priorities of funding for various public services. Given limited and finite tax dollars in the foreseeable future, the state will need to scrutinize spending for its value to people and its contribution to Oregon's economy.

The Executive Committee recognizes this is a time of transformation for state government and for all government – forced by economic necessity. It is a time of challenge and change to the existing structures of government to serve citizens better through the next decade and beyond. It is a time when leaders must unbridle government managers from old systems and provide them the incentives and support to innovate, change and use new tools to meet the future needs of Oregonians. It is also a time for examining how some government services can be financed and provided successfully by other means. If the state is to successfully navigate these waters, it is a time for government innovation and change, and the Governor, Legislature, government managers and citizens all have a vital role in charting a successful course.

State government service delivery can change for the better—not just incrementally, but through a fundamentally different approach to service design. This does not necessarily require more funding. Strategic initial investments in people and technology are usually offset by internal efficiencies and avoided costs as well as by earlier, more effective policy interventions.

What is required is a deeper, more nuanced understanding of citizens' needs, preferences, and capabilities; a realignment of resources to meet these priorities more effectively and efficiently; and the courage and persistence to overcome the resistance and constraints that state agencies typically face when pursuing reform. Part of the challenge lies in effecting major change over periods longer than the usual election cycle. Yet reform remains a vital option for the state, under continuing pressure to rein in costs and deliver services more effectively. Inaction risks swelling the ranks of discontented citizens, missing efficiency opportunities for taxpayers, and watching good policy intentions go unfulfilled.

At the direction of the Governor and the Chief Operating Officer (COO), government managers have a critical role in innovating, making necessary service delivery changes to ensure state resources are spent with positive effect. This means managers must make recommendations about what services should no longer be delivered by state government. It also means managers and the state workforce must be rewarded for collaboration with non-governmental organizations and private sector partners. State managers should have an increasingly important role in the coming years to assist the private sector in creating and retaining jobs in Oregon. As they succeed in this mission, more revenue will be generated to support investment by the state. It will take innovative managers willing to take risks to ensure that quality services are provided, which highlights the need for the state to manage existing issues related to retention, recruitment and compensation.

The Executive Committee is interested in continuing its work with the Governor and COO to make recommendations to advance workforce incentives and rewards that support managers' abilities to excel. The outcome-based budget process presents the opportunity to create an alignment of meaningful incentives.

RECOMMENDATION 1.5: ALIGN THE BUDGET TO SUPPORT MANAGEMENT AND WORKFORCE INNOVATION. The budget should also be used as a tool to encourage and improve management by state agencies. The design of the budget should reward, and not penalize, innovation and savings. The budget should also provide opportunities to invest in the most effective service delivery mechanisms, including non-governmental providers, where appropriate.

Section Two: Fiscal Sustainability and Cost Drivers

Fiscal Sustainability

The 10-Year Plan must work for Oregonians by creating a path to fiscal health while supporting effective programs that citizens value. Before laying out the general recommendations, it is important to understand the context under which the Committee operates.

The work of the 10-Year Plan Executive Committee centers on the concept of fiscal sustainability. The Committee's job is to identify and recommend systemic actions that can be taken to align the budget with available revenues over a 10 year period.

The recommendations are made in what could be described as a zero sum framework of "living within our means." A working assumption of the Executive Committee is that it does not have the latitude to propose tax increases. Any perceived need to raise taxes to elevate a policy objective of the 10-Year Plan is a decision for citizens and policy makers to make and beyond the scope of the Executive Committee. However, this does not exclude recommendations about efficient utilization and organization of the revenue Oregon's tax system currently brings in (these issues are primarily addressed in Section 3: Budget Stability).

Given this constraint, the recommendations about allocating state resources to the highest impact outcomes and the results that citizens desire are made within the context of balancing the budget over the next 10 years.

At the outset of this report the long range forecast of revenues and expenditures for the next 10 years projects a future of revenues just exceeding growth of current budget programs. This means to increase funding for educational or job creation priorities in the future, the budget must produce less of some things in order to fund the higher priorities citizens have identified through the outcome-based budget process. Yet, the budget will grow over the 10-year period, so the state can gain room in the long term by holding some areas of spending flat or less than growth projections.

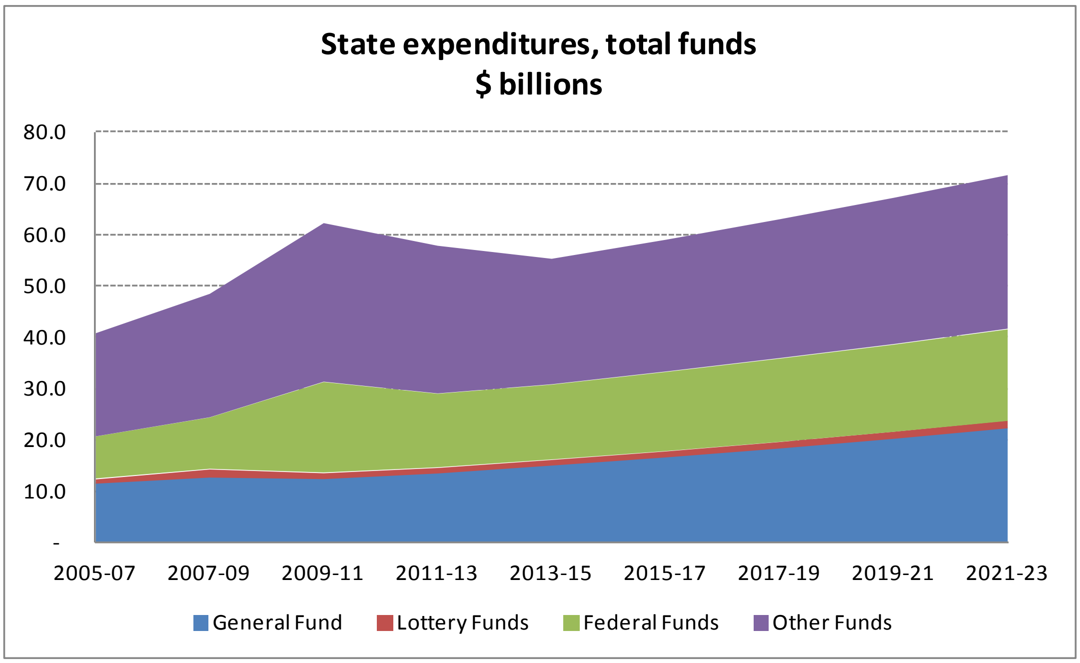
The Committee made extensive recommendation about the outcome-based budget process. To further the aim of supporting a sustainable budget in the future, this report turns to the primary drivers of growing cost within the budget. These recommendations are made at a very high level; they represent systemic cost drivers that significantly impact all state service operations.

Cost Drivers and Recommendations

The overall budget for state government of Oregon is primarily driven by demographics, health care costs, public employee compensation and public safety costs associated with various ballot measures approved by citizens. As population among various age cohorts increases, demand for public services increases in lock step, particularly services catering to elderly citizens.

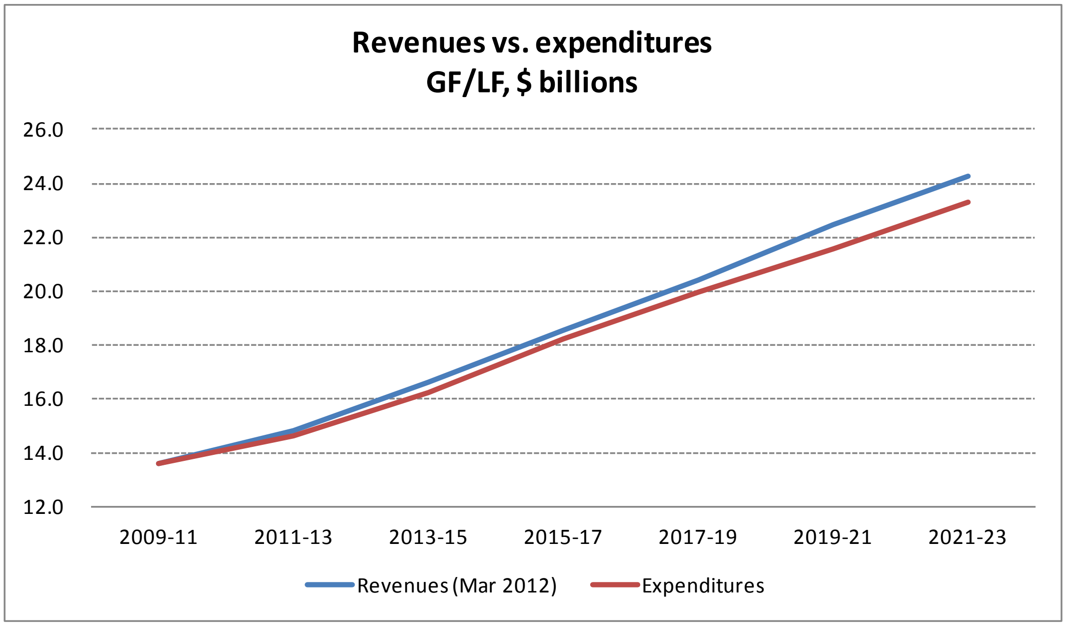
The context for the Executive Committee's work surrounding spending is illustrated by the following two graphics. The first illustrates total state spending over the next 10 years, by fund type. The second depicts a projection of General Fund and Lottery Funds (discretionary revenue) and spending over the next 10 years. Revenues grow from about $15 billion today to about $25 billion in 2021-23, with expenditure levels that are just under available revenue.

Figure 4: Total state expenditures by fund type



Source: State of Oregon, Budget and Management Division

Figure 5: State General Fund and Lottery Funds revenues and expenditures



Source: State of Oregon, Budget and Management Division, Office of Economic Analysis

Figure 5 above clearly shows that projected economic growth alone will not create an ability to invest in necessary changes in state programs because revenue growth and expenditures grow at similar levels, leaving no "savings" to invest. Figure 5 incorporates the loss of $3.5 billion in revenue and corresponding reductions of services and programs that could no longer be funded in the 2011-13 budget period. To be clear, it is that reduced level of services that is then projected forward over the 10-year planning period.

If state government is to establish new patterns of investment it will come from a restructuring of spending within the funds available, rather than a dependence on incremental revenue growth.

Demographics

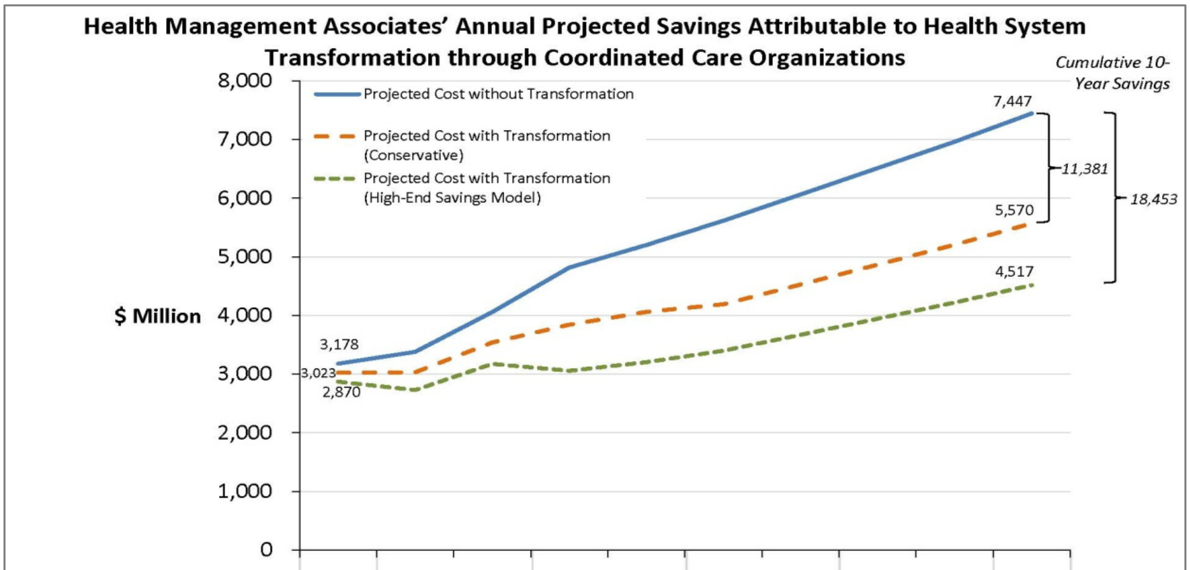
Since 1950, Oregon's elderly population (age 65 and over) has more than tripled, while the total population has nearly doubled. Growth among the elderly was slow until 2004, largely due to the depression era birth-cohort reaching retirement age. However, the trend has already started to reverse and will continue at a faster pace of growth. Beginning in 2011, this population group will consistently exceed four percent annual growth rates. Between 2011 and 2013, the number of young elderly (aged 65 to 74) will increase by 15.1-percent as the early baby boomers enter this age group, far exceeding the state's overall growth rate and at the fastest pace of all age groups. During the same period, the number of oldest elderly (85 plus) will increase by 3.9-percent. The number of persons aged 75-84 has just transitioned from a period of negative growth to slow but steady growth. The young elderly require relatively little government assistance, while persons aged 85 and over tend to require more public assistance. Many members of the senior population require health care, pension support and special housing. They are highly dependent on state long-term care and health care services.

The growth of Oregon's elderly population is the most concerning demographic trend to the Executive Committee in terms of cost impact to the state budget and for this reason it is singularly highlighted in this report.

Health Care Costs

The cost of health care expenditures in state government come from two major categories – costs associated with provision of Medicaid and costs associated with health care for state employees. An estimated 80-percent of health care dollars are expended on 20-percent of patients, mostly for chronic care in the elderly population.

Figure 6: Health care cost savings from transformation



	12-13	13-14 14-15	15-16 16-17	17-18 18-19	19-20 20-21	21-22
Costs w/o Transformation	3,178	7,440	10,019	11,680	13,474	7,447
Costs w Transformation (Conservative)	3,023	6,571	7,904	8,720	10,069	5,570
Costs w Transformation (High Savings)	2,870	5,903	6,260	7,068	8,165	4,517
Annual Savings (Conservative)	155	869	2,115	2,961	3,405	1,877
Annual Savings (High-End)	308	1,536	3,759	4,612	5,309	2,929

Source: Health Management Associates
Notes: Health Management Associates' projections end in 2019. The 2019-2021 biennium and 2021-2022 state fiscal year were extended forward by the Oregon Health Authority by applying the growth rates in HMA's model.

Failure to control the growth in health care costs would be a dire outcome for the 10-Year Plan. The high risk of health care cost escalation could easily consume all growth in the budget, while pushing aside greater investments in education, prevention and other vital areas of the budget. From the perspective of the Executive Committee, the cost control and quality improvement focus of health care reform is not optional. System redesign and transformation is essential for the sustainability of both the state budget and the overall economy.

To this end, the Executive Committee recognizes that the Governor has a large transformation effort under way to redesign the health care system in Oregon to:

- Improve the lifelong health of Oregonians.
- Increase the quality, reliability and availability of care for all Oregonians.
- Lower the cost of care for all Oregonians, so that health care is accessible.

In the 2012 legislative session, Oregon legislators and the Governor came together to pass significant legislation improving health care delivery, specifically Oregon Health Plan Transformation (Senate Bill 1580), and the Oregon Health Insurance Exchange (House Bill 4164).

Senate Bill 1580 creates "Coordinated Care Organizations" (CCOs) that will coordinate the delivery of physical and mental health services for Medicaid patients. The CCOs will be locally organized and governed according to the unique health care delivery system in each of Oregon's communities. The goal is to prevent expensive hospital visits, unnecessary procedures and other inefficiencies caused by lack of care coordination among various providers for this population.

House Bill 4164 creates an online marketplace for individuals and small businesses to purchase health insurance. It allows customers to compare plans and choose the best one for themselves or their family. It also makes purchasing health care easier for individuals and small businesses, while requiring insurance companies to compete on cost and quality.

RECOMMENDATION 2.1: CONTINUE HEALTH CARE TRANSFORMATION EFFORTS TO REDUCE UNSUSTAINABLE COST INFLATION. Both of these efforts are keys to reducing high growth in state costs for health services.

Public Employee Compensation

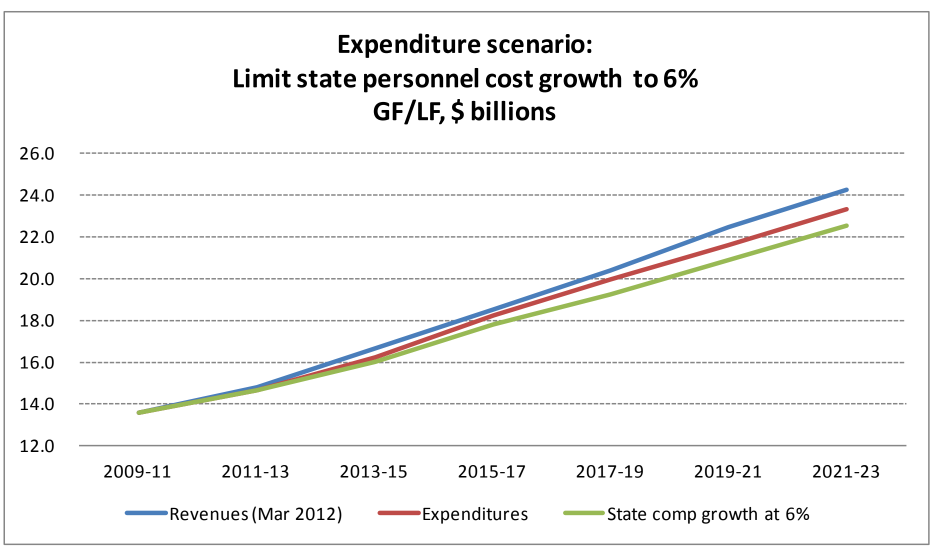
Public employees provide critical services to Oregonians. State government must ensure that the level and structure of total compensation is both a fair recognition of public service and adequate to attract and motivate talented and productive employees. The state also must ensure that the total compensation is not disproportionate relative to public resources available and the economic reality of taxpayers. Total compensation of public employees represents a large share of the total costs of public services; the amount spent as compensation determines the level and quality of services the state can provide to citizens, given limited resources. Increasing total compensation beyond revenue projections while reducing the workforce that provides direct services – be they teachers, case workers, or health workers – is counter to citizens' expectations for their government to provide the most service possible with the resources available.

Controlling costs in the state budget necessarily involves controlling labor costs. However, such controls should not be arbitrary. When the economy is growing and non-state employees' total compensation grows slowly in tandem with the economy, the state should align its budget for labor costs to reflect those trends.

Total compensation is also a major cost driver for public schools. Though the state funds the majority of K-12 education costs, the current service delivery structure creates a disconnect that prevents the state from influencing total compensation costs at the local level over time. The principle that state employees' total compensation costs should align with all working Oregonians when it comes to pay and benefits, should also apply to the total compensation of school district employees.

Total compensation and alignment between the public and private sectors should address the skills required. The state compensation philosophy must be clarified for the future to ensure that employees are paid wages and benefits commensurate with similar jobs throughout Oregon, with the understanding that such a philosophy cannot devolve into "a race to the bottom" wherein low market-rate wages drive wages lower in the public sector. In some cases, such as health care and early childhood, the public sector should look to lead the market to better reward work that is undervalued in the economy overall but is critical to society. This is important for the state's ability to attract qualified career professionals to lead agencies and programs and provide direct services into the future. Fairly implemented compensation systems based upon comparable work in the private sector, and consistent with Oregon's values, will align total compensation with the broader labor market.

Figure 7: Expenditure scenario limiting personnel cost growth



Source: State of Oregon, Budget and Management Division, Office of Economic Analysis

As shown in Figure 7, limiting state employees' total compensation growth to six percent per biennium, as compared to the standard 13-percent, would reduce total expenditures by approximately $750 million, or three-percent, in the 2021-23 biennium.

RECOMMENDATION 2.2: LIMIT ANNUAL INCREASES IN TOTAL COMPENSATION FOR STATE EMPLOYEES TO NO MORE THAN THE INCREASE FOR ALL WORKING OREGONIANS.

The increase in compensation for all working Oregonians is projected to be three percent per year over the next three years, according to the state Office of Economic Analysis. The state can accomplish this cost control without reducing employee paychecks. It could restructure the retirement programs, in addition to the steps the Governor has already taken to control health care costs. Controlling health benefit costs is critical to keeping the cost of state employees' compensation in step with that of all working Oregonians.

RECOMMENDATION 2.3: IMPLEMENT GREATER BUDGETARY ACCOUNTABILITY FOR FUNDING TOTAL COMPENSATION COSTS.

Recommendation 2.3 encompasses a variety of issues typified by negotiating tactics and strategies by all participants during collective bargaining. A well recognized problem is that the Legislature frequently under funds increases in compensation to bolster the state's economic position. The state will, by definition, almost always agree to labor contracts that exceed the budget, which creates a budget imbalance that then needs to be shifted from programs in agency budgets.

Second, compensation costs are not negotiated symmetrically with each two-year budget period, or with targets for future budgets. The most recent labor agreement process exemplifies this problem because unexpected higher labor cost growth was placed into the next biennium, though expressed targets for the level of growth in the agreement were arguably met.

Third, compensation costs are not well accounted for in the budget and these costs need to be transparent, clear and defined from the beginning of one budget period until the next; the detail of labor costs should be discrete and all aspects of cost and benefits should be concurrently considered.

The Executive Committee makes this recommendation because both labor and management need a clear understanding of the multi-year impact and growth of the budget. It does not in any way seek to limit the practice of collective bargaining. The general thrust of this recommendation is that costs must be more transparent, negotiated comprehensively, and negotiated in a way that does not unbalance the budget as agreements are reached. These are major process changes and the Executive Committee recommends that labor negotiations should precede the budget with total compensation built into budgets prior to legislative approval.

To accomplish this, cost accounting and budgetary system improvements will be required. Investments in the systems that allow the state to determine and review cost with greater clarity, and to understand how such costs are incorporated into the budget are vital. The Governor and the Legislature should place a high priority on improving aging and inflexible financial systems that the state has relied upon for many years.

These information generating systems are crucial to budget transparency and to outcome-based, information-driven budgeting practices.

Public Safety Ballot Measures

In 1994, Oregon voters passed Measure 11, which implemented mandatory minimum sentences for person crimes ranging from robbery to murder, effective April 1, 1995. The minimum sentences were considerably longer than the existing guidelines, which caused a substantial increase in the number of inmates in prison over the ensuing years.

In 2008, Oregon voters passed Measure 57, which implemented mandatory minimum sentences for property and drug crimes, effective January 1, 2009. The measure also made addiction treatment available to those repeat offenders who needed it. The 2009 Legislature suspended implementation of Measure 57 until January 1, 2012, at which time the number of inmates is expected to increase steadily in the ensuing years.

Since the passage of Measure 11, the inmate population has nearly doubled, reaching over 14,066 as of October 2010. As a result, the General Fund budget for the Department of Corrections has increased 157.3-percent over the same timeframe. The department is expecting the inmate population to grow by nearly 500 beds during the 2011-13 biennium, primarily as a result of Measure 57. The General Fund Current Service Level budget will increase 21.9-percent to $1.5 billion in 2011-13. At the projected rate of growth, the department projects needing to have a 532-bed facility open by March 2015.

RECOMMENDATION 2.4: THE PUBLIC SAFETY COMMISSION WILL BE MAKING RECOMMENDATIONS TO THE GOVERNOR AND LEGISLATURE CONCERNING MATTERS OF PUBLIC SAFETY. These recommendations are anticipated to provide for citizen safety and address the issue of growing public safety expenditures.

Fiscal Sustainability Recommendations

The Executive Committee makes three additional fiscal recommendations to provide for budget sustainability and the durable provision of state services.

RECOMMENDATION 2.5: IMPROVE REVENUE COLLECTION EFFICIENCY. The Governor and Legislature should implement the management actions identified in the August 2011 Secretary of State Audit Report, *Department of Revenue: Filing Enforcement and Collections Recommendations Follow-up*.
The Secretary of State's recommendations detail management actions to improve tax collection efforts. Though there are many management actions in process, a central issue is the financing of new core

information technology systems. This investment is highly dependent on state policy decisions which require diligent work on the part of the Governor and Legislature prior to the next legislative session.

RECOMMENDATION 2.6: AVOID MAINTAINING ONGOING PROGRAMS WITH ONE-TIME FUNDS. The Governor and Legislature should not make it a practice of using one-time funds to fill budget deficits and fund ongoing programs. One-time funds should only be spent on one-time items.
Certain common practices in state government budgeting (use of one-time funds, automatic roll-up of costs and relying on unspecified spending cuts) have caused great budgetary distress over the last decade. These actions might increase "flexibility" in the short run, but using them has diluted accountability for specific reduction choices. Limiting the availability of these actions helps bolster the case for having a more robust reserves policy.

RECOMMENDATION 2.7: THE GOVERNOR AND LEGISLATURE SHOULD PROVIDE FURTHER ANALYSIS OF CAPTIAL PLANNING AND UTILIZATION OF DEBT. This analysis should be accomplished in conjunction with the State Treasurer and provide recommendations for improved capital expenditure planning and integration with 10-Year Strategic Plans of the state.
The committee did not spend extensive time on analysis of capital planning and use of debt. Nevertheless, this is an issue of relevance to long-term budget sustainability and merits further discussion to integrate these longer-term finance issues with the 10-Year Plan.

Section Three: Budget Stability

Beyond "Boom and Bust": Implementing a 10-Year Strategy to Achieve a Sustainable Rate of Reserves and Improve Budget Sustainability.

Even though the General Fund is dependent on income taxes, the undesirable outcome of bouncing through budget periods by making program reductions can be substantially moderated by changes in what the revenue forecast is asked to predict, and by a policy of scaling-up the rate of reserving over the next decade.

By informed design, Oregon can have a far more stable budget over the next 10 years even if it remains dependent on income taxes. As citizens look for the state to make modest investments to restore the vitality of programs in coming years, and as the outcome-based budget identifies prevention investments to lower cost or improve services in the future, investment in the stability of those very programs is of equal importance. It is wasteful of all interests' time, energy, and effort to secure new investments in one budget period only to see those investments cut away in the next budget because of revenue shortfalls. This all too regular occurrence does not serve the public's interests because those interests extend beyond two-year budget time frames.

If the state cannot reform current practices of budgeting to available revenue and failing to provide for adequate reserves, the programs and services the state provides through its two-year budget remain exposed to a higher frequency of disruptive shortfalls.

Forecasting Revenue

The Executive Committee is focused on high-level issues to advance actions to improve state forecasts and policy makers' understanding of forecast limitations, and to utilize forecasts to frame a fiscal policy for Oregon that provides increased stability. Properly viewed, the forecast is an incredible tool to advance long-term planning, and it is amazingly accurate; but small near-term variations in the forecast can lead to significant budget problems when the budget level is set to mirror the forecast.

To be clear, the Office of Economic Analysis provides an outstanding service for the citizens of Oregon. The peer-reviewed methods of technical analysis of the economy and revenue collections used to create the State of Oregon's Economic and Revenue Forecast are "state of the art."

However, by tying spending levels directly to the revenue forecast, policymakers do not account for the limits of the forecast to predict revenue or the future economy. The state forecast is a great tool and extremely useful to planning sustainable patterns of spending; however, how the state uses the forecast to determine current spending levels is a formula for continued budget instability.

- In practice, the forecast is a spending limit. The state budget often finely matches program spending plans in spite of forecast limitations and this practice increases the likelihood of budget shortfalls.
- Revenue forecasting is volatile because taxpayer choices about realizing income are volatile. Since income is not generally realized for tax purposes at the same time it is earned in the economy, and because income comes in a variety of forms and not just wages, it is challenging to anticipate taxpayer behavior given a set of economic conditions.
- Economic forecasting is not a strong early warning device for significant economic downturns. Even when it can be established that the economy is very vulnerable to recession, the timing of future turning points in growth is very difficult to capture with statistical models.
- Oregon relies on accurate forecasting to determine whether it retains revenue from economic growth. If actual collection of revenue exceeds the forecast by two-percent over the biennium, it triggers a rebate of all revenues above the forecast to taxpayers.

State revenue forecasts are a vital planning tool of government, but state fiscal policy is overly dependent on the precise level of the forecast. The state must consider fiscal policy changes that take into account the technical limitations of forecasting. To preserve budget stability as such, forecast errors lead to unstable program funding. As a matter of policy, Oregon should base its budget on predictable and stable revenue and impose reserving practices that control spending levels and protect programs.

The following section of this report will explore why a continued dependence on revenue forecasts is not sufficient to provide budget stability. It will also use historical forecast data and projections to illustrate scenarios that will increase budget sustainability. An obvious way to address this would be to impose a limit on spending to some percentage less that the forecast; the Executive Committee is advancing a different approach to increase reserving over time (see recommendations below, page 31).

Forecast Operates As a Spending Limit

During the regular session of the Legislature, sessions that occur in odd-numbered years, there is a moment in time in May that signals the beginning of serious work to produce and adopt a Legislatively Approved Budget (LAB). May is also when the State of Oregon, Office of Economic Analysis offers one of its quarterly views into the future with its Economic and Revenue Forecast. From that point on the Legislature diligently works to produce a two-year spending plan that is balanced at or below the revenue projections for the biennium that begins July 1. The Legislature makes appropriate adjustments to balance their spending plan to this legally binding forecast that defines the level of revenue to which the budget must be balanced. It is not surprising that state budgets tend to closely mirror forecasts.

In times of economic expansion this is not a particularly troublesome prospect; revenues often increase above approved levels of spending by the Legislature at the conclusion of the regular session. When this practice of finely gauging the budget to projected revenues happens in less opulent times, it portends budget shortfalls.

The Legislature does have some buffering mechanisms depending on its will to allocate funds to an ending balance and Emergency Board Reserves. Over the past decade, typically these reserves represented one-percent or less of the entire state General Fund budget. Few effective limitations exist on how closely the Legislature can match spending to the forecast. If revenues fall, the Legislature will come into session to make program reductions to bring the budget into balance – and no Oregon Legislative Assembly has failed to provide for a balanced budget as required by law.

Compounding the tendency to finely tune the budget to the forecast is the fact that the state does not have an adequate reserving policy for times of shortfalls. Also, as a result of the two-percent kicker law it cannot retain in reserve the benefits of revenue growth based on economic prosperity.

Together these practices and policies become a toxic mix for state programs when the economy moves from bad to moderately worse (see model of a moderate recession in Figure 8). As a de facto spending limit, budgeting too closely to the forecast has been a source of continuing budget instability. Oregon needs new fiscal policies to protect the delivery of public services and to control spending up to the peaks of revenue growth and to avoid falling farther when the economy takes a significant dip.

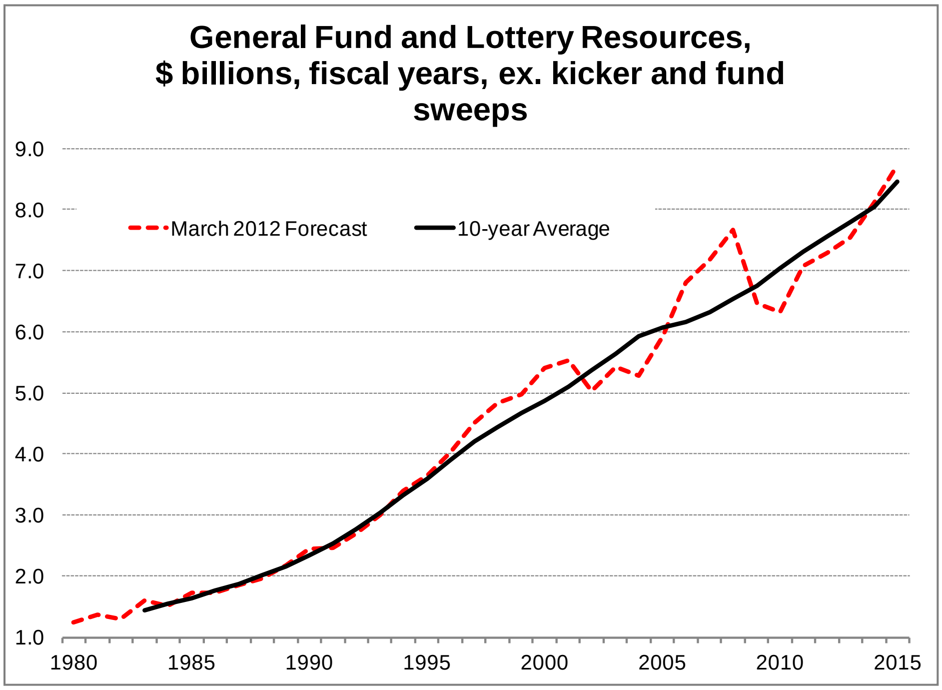
Volatility of Revenue and the Behavior of Taxpayers

Revenue forecasting is an imperfect science. Even if forecasters could predict economic conditions perfectly, policy makers would still need to deal with large swings in the revenue forecast. Many facets of the revenue forecast depend on predicting taxpayer behavior, since income is not generally realized for tax purposes at the same time it is earned in the economy. Most notably, investors have a great deal of flexibility over when they can cash in capital gains and other forms of investment income. Many other questions about taxpayer behavior arise as well. How much will households play the Lottery? How many firms will take advantage of energy tax credits? Given these inherit constraints, it is likely that future revenue forecasts will be volatile because of the relationship between the focus of the tax code; growing income inequality; and volatile financial markets.

Comparing actual and projected revenue trends with a 10-year average of revenues spotlights underlying income tax revenue volatility. The actual revenue line (and projections of actual revenues) moves above and below the 10-year average in Figure 8. Revenue also rises and falls against expenditures which means that Oregon's budget experienced periods of excess revenue and budget shortfalls along the timeframe covered.

Though the risks to forecasting are always noted, policy makers tend to proceed as if the projection is the reality of future balance. On average, that would be statistically true so long as policy makers budgeted to the 10-year average. However, spending practices tend to mirror the ups and downs of the actual revenue line and two-year forecasts.

Figure 8: Actual and projected revenue trends



Source: State of Oregon, Office of Economic Analysis

Mathematically, the areas of revenues above and below the 10-year average line are equal. If Oregon had only spent to the 10-year average and saved funding above the line, it would fully make up for the points at which revenues fall below the 10-year average. While achieving that perfection of budget balancing is hypothetical, understanding this is a good indicator of the policy and principles that should be applied to stabilize the budget. It reinforces the idea of saving money during times of growth to fund times of economic downturn and is consistent with the stated principles of the 10-Year Plan project.

With regard to the accuracy of the forecast, it is important to understand that some components of income taxes are more sensitive to economic variation than others. Though several volatile income tax components exist, variations in capital gains and other nonwage forms of income are highly correlated with recent swings in the revenue forecasts. These revenues increase dramatically during periods of economic growth only to dramatically decline during recessions. Realized capital gains in Oregon fell from $9.6 billion in tax year 2007 to $2 billion in tax year 2009.

The difficulty in accurately forecasting capital gains, profits and other forms of investment income from one two-year budget period to the next means that the state forecast will continue to lack the accuracy necessary to avoid related budget shortfalls so long as spending is aimed to match near-term revenue forecasts. Regardless of a philosophy about the taxation of capital gains a simple step to improve the accuracy of the forecast would be to dedicate this revenue, and other difficult to predict components of income taxes, to reserves. Shifting capital gains revenue to reserves would moderate increases and decreases in state spending; a corresponding benefit would be the improved accuracy of the forecast because it is better at predicting income taxes related to earnings and employment trends.

Oregon's revenue forecast is produced based on current law and does not predict any future actions of state policy makers no matter how likely those future actions may be. The Legislature recently took the positive action of scheduling a portion of tax expenditures for elimination every two years with passage of House Bill 2067 in 2009. Tax expenditures are allocations of revenue that benefit individuals and businesses by allocating tax benefits to them. This revenue is in effect "spending," but the revenue is never deposited into the General Fund. The legislative intent in taking this action was to provide a process for reviewing the tax expenditures to determine if they achieve the desired purposes or if changes would improve the results and benefits of allocating specific tax expenditures.

Certainly another intended outcome was legislative determination that specific tax expenditures should be allowed to "sunset" as designated by law. But, there are related outcomes relative to the revenue forecast. Experience indicates the Legislature is likely to change and continue tax expenditures rather than allow them to be eliminated. The short and long-term revenue forecasts treat these tax sunsets as if actually eliminated (they are eliminated in revenue projections that go beyond 2011 in this report). This has the effect of inflating funds available for general spending. While this is not ideal, prior to this law it took a 3/5 vote of the Legislature to lower tax expenditures. If for the sake of accuracy the law was to change, it would be important to allow the Legislature to control tax spending by majority vote.

Forecast Predicts Downturns Slowly

Geopolitical events and other unforeseen external shocks often derail economic expansions. Even when it can be established that the economy is very vulnerable to recession, the timing of future turning points in growth is very difficult to capture with statistical models. Unfortunately, when looking at two-year windows, the timing of tuning points in the economy has major implications on the amount of resources available to policy makers.

When the economy turned south following the 2001 legislative session, it took a couple of quarterly forecasts before the downward revenue problem was revealed. By December 2001, the Governor and Legislature knew they would have to take steps to moderate the downturn. Because of the depth of that recession, and a lack of savings, the state could not catch up to the growing magnitude of continuing cuts as the "hole" in the state budget grew. The point, however, is that the forecast was not capable of detecting a downturn of such great magnitude, over a billion dollars, even a year into the future.

Analyses of previous forecasts generally show this pattern. In looking at the leading edge of economic downturns, it usually takes a few cycles of forecasting to affirm that a weakness in economic activity indicates a significant economic downturn and then a significant budget problem as income tax revenue declines.

A key reason for this is the timing of personal income tax collections—specifically the April 15 deadline for reconciliation of prior year tax liability – is causing considerable forecast swings in the June forecast. The state has been fortunate to avoid a two to three-percent swing in the last forecast that the budget depends upon. If this were the case the Legislature would have little time to react to a shortfall magnitude from about $300 to $500 million at the end of a budget period, unless it had adequate reserves.

In 2003, the Oregon Legislature approved $450 million in bonding to cover operational shortfalls in the General Fund budget. Those bonds will finally be paid off in 2013. It is not purely coincidental that those bond payments end in 2013 and in 2013 the Executive Committee is recommending an aggressive reserve policy for the next 10 years. The larger context for policy development is that the forecast is inadequate to prevent such dire effects and current policy, in practice, is the reverse of what it should be. Consider that Oregon was making bond payments for operations for the 2001-03 state budget as it worked to overcome shortfalls in the current budget. If Oregon could manage that feat, it can certainly manage to set aside reserves as the economy improves.

Kicker is a Byproduct of a Forecasting Error

It is not the intension of the Executive Committee to belabor the long standing debate concerning the kicker. Nevertheless, this report recommends kicker law changes as a potential resource for funding reserves. The kicker intersects with the forecast as the kicker is triggered by the forecast not being accurate to within two-percent. When revenues exceed the forecast by two-percent all revenue in excess of the forecast amount is rebated to taxpayers.

Given the prior discussion of the ability of the forecast to predict revenue, and the caution advised in how the forecast is used in relation to a balancing the budget, the same logic applies in the case of the kicker. Other means exist to establish budget limits, define excess revenue, provide for reserves, and provide for a policy of rebating excess revenue to citizens.

For these reason the Executive Committee encourages continued legislative work to broker a new arrangement between citizens and policy makers that provides a framework to logically address and balance the competing policy desires of controlling spending by rebating funds and utilizing funds the tax system brings in to stabilize state finances. The creation of the 10-Year Plan for how Oregon utilizes its resources should help transform thinking about the kind of financial tools necessary to achieve those results.

Constructing a "Fail Safe" Plan to Improve Budget Sustainability

Sustainable levels of program funding and associated cost issues were addressed in the prior section of this report; however, a multi-year program to increase funding for reserves will benefit program stability and is directly related to the concept of sustainability. At the outset of this discussion about stability a clear statement is made that reserving is "of equal importance" as prevention investments and investments that create greater returns on investment or savings. This is of special emphasis because reserves support the stability of prevention investment and ongoing program investments designed to save the state future expenses. In the context of a two-year budget allocation process reserving is a competitive priority for dollars with other priority investments, yet reserves directly benefits the ability of the state to maintain continuity of planned investments in the future.

This creates a choice between the outcomes of today and the outcomes desired for tomorrow. As the economy improves, do Oregonians want state government to focus on making large priority investments knowing that if the economy falters in the future the progress is lost? Or do Oregonians want to ensure that programs invested in today will be protected when revenues take another downturn? The benefit of a 10-Year Plan is that it expands the context for determining whether the choices of today are beneficial to long-term objectives.

As a matter of fiscal stability and sustainability the Executive Committee sees this as a clear choice; maintaining a continuity of support for vital programs is important in each budget. Reserving offers the least disruptive path to efficient service delivery by state government. Deep and recent budget shortfalls, of historical proportions, have provided Oregonians with firsthand experience about the exposure of programs and the risks to citizens when reserves are inadequate.

The Legislature and Governor have worked together to establish the basis for a coordinated PK-20 education system, making the point that Oregon values the entire educational experience of students. Individual two-year budgets that only provide for financial stability during good years, and let investments fall aside in bad financial times, is inconsistent with this vision. It was not that long ago that Oregon's eye was blackened by the national lampooning of its education system in the *Doonesbury* comic strip as days were cut from the school year to make it through a fiscal crisis. If reserves were in place, that journey would have been less painful to Oregon's collective ego and the education process – two years of a student's life – would not have been as severely disrupted. The loss of the quality of the educational experience for these students is not something easily recovered.

The point is simple, reserving does not take something away from priorities – reserves enable Oregon to implement its priorities. If there is some part of magic a 10-Year Plan will provide to help secure prosperity in the future, it will be the change in the collective thinking of citizens and policy makers that the immediacy of the moment need not defer the state from confidently working to achieve its common vision.

Governors and Legislators have made attempts to cushion the state from economic downturns. The state regularly sets aside some money to help maintain programs if revenues drop or the demand for services increases. However, these efforts have been ineffective because reserve funds have not been sufficiently capitalized — it is easier to spend on current needs than to save to protect long-term needs. Typical reserves in any one biennial budget period might amount to one or two percent of the General Fund and Lottery Fund combined. Most of what is reserved is directed by the Oregon Constitution's allocation of Lottery Funds. Reserve funds have been used to balance budgets during recent economic downturns and are now depleted.

The following information outlines paths to take on the longer-term issue of establishing adequate reserves for the General Fund and Lottery Fund budgets. It provides context for the Committee's concluding recommendations regarding reserves and the important role reserves will have in helping to secure stable outcomes in the areas of education, healthy people, economy and jobs, safety and healthy environment outcomes as well as those for improving government.

The Education Stability Fund and Rainy Day Funds

The Education Stabilization Fund (ESF) and the Rainy Day Fund (RDF) are the two primary vehicles for saving money for economic downturns. They have established features of operation, defined sources of fund dedication and similar rules for the release of funds.

Later in this report, it will identify recommendations that the state save or reserve up to a cap limited to 15-percent of the prior Legislatively Approved Budget (LAB), and it will identify the additional funding necessary to achieve a rate of savings to meet that goal over the next 10 years. As the information unfolds, keep in mind that additional increments of saving could go into either of the existing funds (with necessary changes to the existing caps that limit the total funds that can be retained in the funds).

Figure 9: Reserve Funds and Features

Reserves and Requirements	Education Stability Fund (ESF)	Rainy Day Fund (RDF)
Basis of Law	Constitutional	Statutory
Revenue Deposits	• 18% of Lottery Funds until cap is reached. • When the 5% cap is reached 15% of Lottery Funds are placed into an education capital matching fund. • Interest —the ESF does not retain interest on the balance—interest earnings are distributed to pay for past school lottery bonds and needs based scholarships.	• One time corporate kicker deposit 2007 • Up to 1% of General Fund Appropriations in the prior biennium • Portion of corporate income tax revenue above 6.6% rate beginning in 2013 (BM 67, 2010) • Interest
Conditions for Withdrawal	• Declining employment or revenue below 2% of forecast, OR • Emergency declaration by the Governor AND • 3/5 vote of the Legislature	• Declining employment or revenue below 2% of forecast AND • 3/5 vote of the Legislature
Uses of Funds	Public Education	General Purpose
Funds Cap	Fund may grow up to **5%** of General Fund Revenue Collected in the prior biennium	Fund may grow up to **7.5%** of General Fund Revenue Collected in the prior biennium.

Because of the recent budget shortfalls, both the ESF and the RDF have significantly diminished projected balances at the end of this biennium, $9.8 million and $46.1 million respectively. Both of the funds were created after 2000, with the ESF leading the way. Given the turbulent past decade, neither fund has approached limits as the criteria for withdrawals has been exceeded for a good part of that time and the Legislature has rarely maintained a significant ending balance to transfer to the RDF. Nevertheless, reserving dedications have helped to moderate a portion of recent budget shortfalls. It is important to point out that bonding of Tobacco Settlement Funds to seed fund the RDF was not a particularly efficient or effective means to provide funding for reserving; in general, bonding to fund reserves makes little sense as it is simply advanced borrowing to cover a future shortfall.

The Executive Committee believes the construction and features of the current funds with regard to usage are sufficient. The principle focus should not be on devising changes in funds, rather the mantra for action is to "fund the funds." The priority is the identification of fund sources and defining the rate of savings necessary to achieve the desired level of savings.

The Executive Committee's recommendations with regard to the amount of overall reserves, and the guidance for the necessary rate of savings specifically is based on the prior work of the dedicated Oregonians who shaped the "2009 Final Report of the Task Force on Comprehensive Revenue Restructuring." As this task force considered the details of the state's two reserve funds they advanced the following recommendations from the 2009 Final Report of the Task Force on Comprehensive Revenue Restructuring:

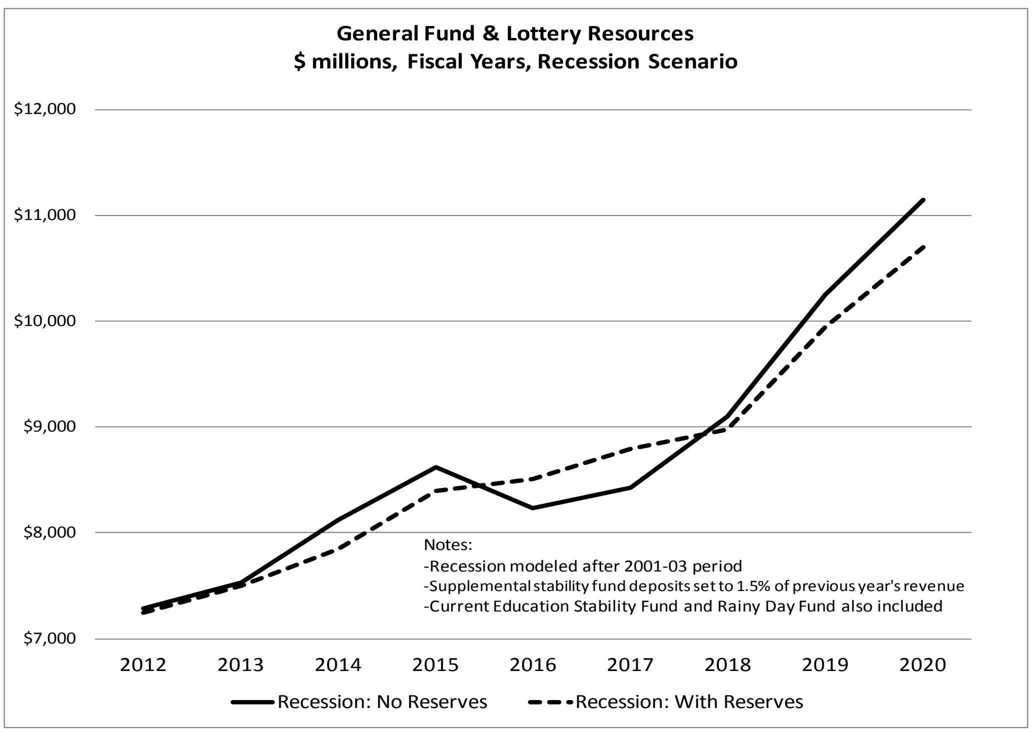
- The target for the reserve funds (the Education Stability Fund plus the Rainy Day Fund) savings rate should be to maintain average growth in spending during the average recession.
- Meeting the foregoing target would require a savings rate between three-percent and four-percent of General Fund revenue during expansions.
- The maximum for the reserve funds, taken together, should be 12-percent to 15-percent of the biennial budget.
- The current policy of adding the General Fund ending balance up to one-percent of General Fund appropriations should be continued. However, historical analysis shows that this method would not be sufficient to fully fund the current Rainy Day Fund.
- Sources should be identified that would provide an additional 0.5-percent to 1.5-percent of General Fund revenue on average during periods of economic expansion.
- One proposal is to change the forecast method to allow for any revenue up to one standard deviation above the current forecast method to be allocated to the current Rainy Day fund. Historical analysis shows that this change is recommended as the most promising method of additional funding.

What is clear from the work the task force produced is that Oregon is not adequately saving to protect services from economic downturns. The standard for budget reliance as defined by the task force was based upon achieving a 50-percent to 75-percent probability of having sufficient resources in the funds to cover shortfalls. Like a deductable on insurance, the design of this recommendation assumes some continued risk. Relatively speaking, if Oregon was reserving all funds available to be reserved under current law, it would take approximately two-percent of additional reserving to meet the essence of the Task Force recommendations.

Modeling Savings Plans

To provide context for a discussion of reserving and the operation of reserves to protect the budget, two models of reserves are created. One is aggressive and provides the state more protection across the next 10-year period, the other is a deliberate path of increasing dedications to reserves to build up to adequate rates of automatic reserving within five biennial budgets.

Figure 10: Aggressive Reserving Moderates Shortfall by 50-percent



Source: State of Oregon, Office of Economic Analysis

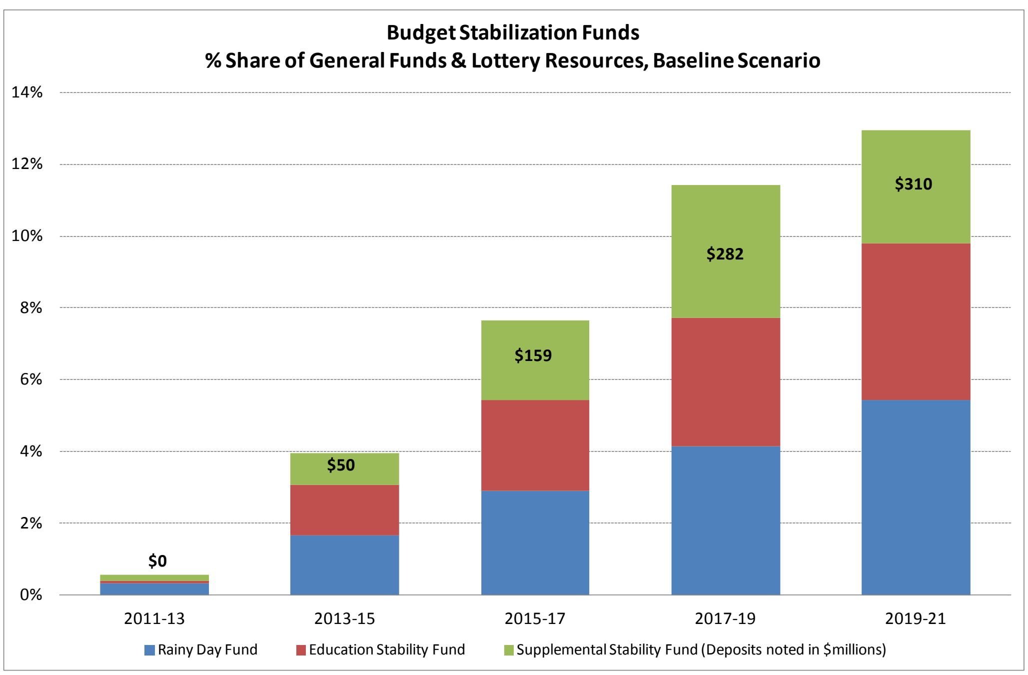
Figure 10 illustrates the impact of a future recession scenario of about the same magnitude as the technology bubble recession of 2001 on state revenue collections (budget shortfall). The recession is characterized by about a four-percent drop in the number of jobs.

This scenario assumes an increase in total reserve funds of $100 million per year beginning in 2014, and only $50 million in 2013. It accounts for all dedications of revenue and growth in the ESF and RDF reserves and the withdrawal of those funds. The conditions of use that apply to the ESF and RDF are applied to the withdrawal and use of the additional contribution of $100 million per year (with the exception of the first year).

The "2001 recession" scenario occurs in the 2015-17 biennia, and results in about a $2 billion shortfall. This additional reserve contribution, in combination with reserves already provided for by law, reduces the shortfall by half, or about $1 billion. Saving $200 million in each budget period prior to the downturn allows a 50-percent moderation of the shortfall in the Figure 10 scenario. In the example, the cushioning of the downturn is achieved with "savings" from a four year accumulation of funds dedicated to the ESF, RDF, an addition of $100 million each year (except when funds are withdrawn). If the example-recession were placed in the 2017-19 budget period, the state would be in an even better position to sustain programs.

This scenario demonstrates the value of a relatively aggressive increase in near-term reserving to stave off the worst effects of an economic downturn within 10 years. On average, a downturn of the magnitude modeled is statistically probable but not by any means a certainty. The next model is less aggressive in savings and focused on building reserves in a scalable fashion of achievable steps from one budget period to the next.

Figure 11: Moderate Saving Plan to Achieve 15-percent Reserve in 10 Years



Source: State of Oregon, Office of Economic Analysis

Figure 11 shows the evolution of reserve funds under a scenario designed to produce five-percent of General Fund set asides by the 2021-23 budget period and thereafter. This model is designed to replenish reserves up to 15-percent of General Fund resources every three budget periods (six years). The display above does not include a representation of total reserve funds for 2021-23 as the underlying data tables to produce that display will not be available until the May 2012 forecast. It is important to understand that Figure 11 assumes that a full one-percent of General Funding ending balance is transferred to the Rainy Day Fund each biennium. Also, the scenario does not show the affects of a recession triggering withdrawal of reserve funds.

The moderate savings plan is based on a gradual increase in reserves over the next five biennial budgets (10 years). At first, additional deposits are assumed to be small in light of the many competing demands for current resources. An additional $50 million reserve deposit is assumed to be made in the 2013-15 biennium and then increase each biennium thereafter. This design would enable Oregon to meet the 2009 Revenue Restructuring report's goal of 12-percent to 15-percent reserves by the 2021-23 biennium.

Enacting a Reserving Policy

The Executive Committee believes a target for the reserve funds saving rate should be to maintain current levels of spending during the average recession.

RECOMMEDATION 3.1: ESTABLISH A ROBUST RESERVE FUND WITH A DEDICATED REVENUE STREAM TO ENSURE ONGOING AND ADEQUATE FUNDING LEVELS. As a guide the Executive Committee recommends aggressive savings targets, certain fund protections in law, and at a minimum, adoption of a "fail safe" approach in legislation to require reserve standards are met over the next 10 years.

- **The combined cap for all reserves should target 15-percent of General Funds.**
  - The ESF and RDF combined cap is 12.5-percent.
  - A means to increase total authorized reserves by 2.5-percent would be necessary (such as amendment of an existing reserve fund cap or creation of another fund).
- **The cycle for savings should be three biennia (six years).**
  - A third of the 15-percent equals savings of five-percent of General Funds for each budget.
  - Functionally this means achieving additional savings of about 1.5-percent per biennium.
  - Six years roughly matches the timeframe, on average, of economic or business cycles (although in recent years frequency of downturns has increased).
- **A savings rate should be constitutionally defined and protected.**
  - This should not be a limitation on initiating a savings plan; it is practical that an immediate action plan be statutory and provide a "glide path" of incremental increases in reserves over a 10 year period.
  - As savings sunrise and increase to meet the desired savings rate over the next 10 years, the increment of additional funds to meet a constitutional savings target will be nominal steps within each budget rather than a disruptive and difficult diversion of General Funds. The law must designate the rate for each step.

- The Legislature In 2013 should adopt the 10-year savings plan in legislation and refer to the voters an amendment to the Oregon Constitution that provides for a permanent rate of reserve set asides to become effective in 2021.

o **Savings will not be required in budget periods in which the conditions for withdrawal of reserves are met.**

The following five alternatives are viable sources of funding for reserves. The Governor and Legislature should evaluate and select alternatives that provide sufficient resources to meet established dollar targets for an aggressive or moderate approach to achieving adequate reserves.

1. **ANALYZE THE TOTAL COST OF TAX EXPENDITURES AS A BUDGET ITEM AS A POTENTIAL SOURCE OF FUNDING FOR RESERVE FUNDS. The Governor and Legislature should review all tax expenditures for their cost, effectiveness and value to the state. Responsibility for achieving reductions should be a primary responsibility of the revenue committees and the Joint Committee on Tax Credits. Tax expenditures that do not deliver their intended purpose should be eliminated and phased out with savings directed into reserve funds.**
   Tax expenditures have grown precipitously over the last 10 years, faster than the state budget overall. Most of this growth is in federal exclusions ("above the line" of Adjusted Gross Income) and deductions. There needs to be more analysis, oversight and transparency surrounding Oregon's tax expenditures. Like budget expenditures, a system of limits and controls should be imposed on the overall spending and allocation of revenue benefits to business and individuals.

   The Committee recommends accelerating the current schedule of tax expenditure sunset review, as required by the Legislature. Since many adjustments of income and tax exemptions have merit, and few are ever terminated, a graduated approach of adjusting deductibility or credits on income tax forms may be a productive path for shifting policy over time.

2. **CONSIDER A PLAN TO REDUCE INCOME TAX EXPENDITURES OVER TIME AND DEDICATE A PORTION OF THE ADDITIONAL REVENUE TO BOLSTERING THE STATE RESERVE FUNDS. Consider rolling back overall income tax expenditures by 1.5-percent of potential revenues each year for 10 years as a source of funding a reserve fund.**
   Along with the reduction targets, the state should enact an automatic adjustment mechanism that keeps the policy of shifting tax expenditure saving to reserve funds over the course of the next decade. The mechanism should have the same force in law that the Office of Economic Analysis' revenue forecast has.

   This approach need not rely on the elimination of specific tax expenditures, but would require incremental rolling back of tax expenditures in whole or part and is responsive to the political difficulty of full elimination of existing benefits. In other words, this need not be an all-or-nothing discussion.

3. **ANALYZE APPROPRIATENESS OF DEDICATING A PORTION OF THE VOLATILE COMPONENTS OF INCOME TAX COLLECTIONS TO RESERVES**.
   The Joint Legislative Committee on Revenue, the Office of Economic Analysis and the Department of Revenue should evaluate the impact of volatile income tax components on state revenues. The Governor and Legislature can then integrate the timing and fiscal impact of shifting components of this volatile revenue to the Education Stability Fund (ESF) over the next 10 years.

   Income is not solely derived from wage earnings, and the state defines and collects income in many ways. Some of these income types are more sensitive to economic cycles, and thus, collections vary greatly from year to year. These more volatile components of the income tax system could be placed directly into the ESF as its usage is constitutionally protected to fund education – the largest component of the state's General Fund budget. Also, collection of estate taxes vary from year to year, and for that reason, transfer of these taxes to reserves is also appropriate for consideration.

   This action could provide three direct benefits to citizens and Oregon's fiscal sustainability: 1) enhance program stability during economic downturns; 2) increase accuracy of revenue forecasts; and 3) cease funding ongoing state programs with these volatile sources of revenues.

4. **DEPOSIT $100 MILLION INTO RESERVE FUNDS IN EACH BIENNIAL BUDGET FOR 10 YEARS. Create a separate line item in each budget for a deposit into the Education Stability Fund (ESF).**
   As determined by the Task Force on Comprehensive Revenue Restructuring, the target for the reserve funds savings rate should be to maintain average growth in spending during the average recession. The maximum balance for both the ESF and the Rainy Day Fund (RDF) should be 12-15 percent of the biennial revenues. This should be sufficient to maintain spending through most recessions. Current maximums for the two funds would achieve the lower end of this range when both are fully funded. This could be accomplished by direct appropriation from General Funds or changes could be made to the constitutional allocation of Lottery Funds.

5. **EXPLORE MODIFICATION OF THE KICKER AS A MEANS OF FUNDING THE RESERVE AND REDUCING BUDGET VOLATILITY.**
   The Committee has not discussed any particular mechanism for modification of the kicker. However, the Committee is aware of recent legislative work to identify modifications to smooth both the peaks and troughs of Oregon's revenue system and provide an ongoing funding source to build a robust reserve. The kicker is a derivative of the accuracy of forecasts, is asymmetrical applying only to under-projections and rebates are produced when revenue collections exceed the forecast by two-percent or greater (a forecasting error). A narrow reliance on the forecast for maintaining a balanced budget is problematic because of the factors making the forecast volatile; the same analysis could be made with regard to rebating policy. In either case, improving the forecast by focusing it on stable and more predictable income tax revenue sources is a benefit to budget sustainability.

Section Four: Conclusion

Oregonians are faced with many choices to create a more diverse and stable budget. Choices that will allow Oregon to do a better job managing its volatile revenue structure, and choices about the most important spending priorities — and a very important choice about having the discipline to create reserves that are adequate to accomplish the goals of Oregonians without disruption.

Oregonians do not need to take action in one year; this plan provides a sensible decade to accomplish the mission of providing fiscal stability and shifting spending to the services important to all citizens. Today all that is required is to make a choice to take the first steps forward together.

The Executive Committee does not pretend to have all the answers. The Committee has offered a plan and ideas as the starting point for a serious statewide conversation in which every citizen has an interest, and all should have a say. Leaders have a responsibility to inform citizens about the choices the state faces, and to enlist the ingenuity and determination of Oregonians in rising to the challenge.

The Executive Committee urges the Governor to continue to advance this work; members of the Executive Committee stand ready to help that effort and to provide continuing advice to the Governor.

As a concluding recommendation for this phase of the process, the Executive Committee encourages the Governor to utilize this fiscal report as a platform for a broad discussion with legislators and the citizens of Oregon. While the report captures the essential elements of what must be accomplished to provide Oregon a sustainable and stable budget, the recommendations can be vastly improved through a more encompassing process of engagement.

There is no doubt that Oregon would benefit from the development of a working consensus to pursue a common course to a stable future. The Executive Committee hopes this work establishes a strong foundation, contributing to that goal and to the enactment of a 10-Year Plan for Oregon.

This is an evolutionary process and the Executive Committee has a vision that the work of creating a new outcome-based budget and 10-Year Plan can lead to productive consideration of all its vital elements during the 2013 legislative session. The work products should be offered into a legislative session and to leaders, regardless of party, that see their role of providing even greater public engagement and effort to the development of the plan and budget. This is clearly an achievable vision. Over the next year, the focus of citizens, legislators and the Governor should be on achieving that result.